Introduction to the Accounting Process

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First edition

Noordhoff Uitgevers

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Noordhoff Uitgevers Groningen | Houten

Cover design: G2K Designers
Cover illustration: Photodisc

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0 1 2 3 4 5 / 14 13 12 11 10

ISBN (ebook) 978-90-01-84933-7
ISBN 978-90-01-78923-7
NUR 786

Preface

This is the first English edition of the Dutch version of *Introduction to the Accounting Process*. This edition incorporates certain changes. This edition includes three new chapters (Part III, International aspects of accounting, chapters 14, 15 and 16). The major change is the internet site that has been added to the book. Part of this site is accessible to students and another is for teachers only. The students' part includes sheets on which to answer problems/do exercises, as well as the solutions to some of these. Solutions to other problems are accessible to teachers only.

The new internet site also includes a case study that can be used by teachers and students to practise both manual and automated accounting.

The number of exercises has been adjusted in such a way that they reflect what happens in businesses.

The text contains references to other chapters so that the student can easily find related information. Key words in the margin help students to navigate their way through the book; these are included in the index at the end of the book.

The course consists of four parts:

Part I: The book-keeping system. In this part students will learn step by step how to record financial facts in the book-keeping system.

Part II: Special accounting entries. Attention will be paid to a number of frequently occurring issues.

Part III: International aspects of accounting, focusing on different formats for financial statements, ratio analysis and cash flow statements.

Part IV: A case study. By working on this, students can judge whether they have mastered what they learned on this course.

All chapters include examples and a number of exercises, which aid students to assess their level of understanding.

Apart from the above-mentioned improvements, a new layout helps guide students through the book.

This introductory course is suited for students in universities and business schools who lack basic knowledge of the accounting process.

Table of contents

Introduction

'Anybody who runs a business is obliged to record his capital and all that concerns his business in such a way that rights and duties can be derived from these records.'

This article in the Commercial Code is still valid. It means that in any business all events influencing assets, receivables or liabilities must be recorded. In the past this happened in a number of 'books', hence book-keeping. Nowadays, the word 'accounting' is applied, though this is more than merely registering financial facts.
Financial accounting is aimed at providing financial information to external stakeholders, such as shareholders and banks. Investors can assess how management has performed its tasks (accountability) and can use the financial information as a basis for future investment decisions, though they should realise that financial statements always relate to previous years.
Another major change, in the final quarter of the last century, was the introduction of the computer. There is hardly any business in which the administration is not automated. Most (mostly small) businesses that do not perform the recording themselves outsource this activity to specialised accounting firms, which apply one of the many computerised accounting programs.
Using a computer does not help anyone understand the accounting process. After making the necessary entries, the computer runs several invisible procedures, and pressing one button will show a new balance sheet and income statement.
The only way to understand book-keeping is to do it manually, preferably with pencil and eraser. After this, it is not hard to switch to automated accounting, realising that the computerised process is identical to the manual one.
In this introductory course students familiarise themselves with the accounting process and the way in which financial facts are recorded manually.

The course consists of four parts. In Part I, the basics of the accounting process are outlined by constructing the accounting system. Part II discusses some common problems, such as VAT, withdrawals and adjustments. Part III focuses on international aspects of accounting. In Part IV, all topics in the course are integrated in a case study. By working on this, students can assess their level of understanding.
The full course is based on the administration of a firm with the legal form of sole proprietor. Later in their studies students will realise that different enterprises with different legal forms will apply the same accounting systems, only with more accounts.
Within the scope of this book, no attention will be paid to internal control, though this does not mean that it is unimportant.

An internet site is linked to this book. The site consists of a part for students and a part for teachers only. Students can find sheets on which to answer problems/do exercises, as well as solutions to some of these. Teachers have access to the solutions of all the other problems. The site also includes a case study, Plug and Play, with three months of financial facts. The case study can also be used in a computerised accounting course.
Since not all teaching institutions use the same accounting program, financial facts for Plug and Play's first month of existence are available on the teachers' part of the site. This enables teachers to prepare the basis of the accounting scheme, which students can use to continue with the facts for the following three months.
This introductory course is meant for students in universities and business schools who lack the basics of accounting.
After successfully finishing this course students will be able to:

- record simple financial facts in journals and sub-ledgers
- prepare journal entries and record them in the ledger system
- prepare the trial balance
- apply the decimal accounting system
- understand the accounting process.

In this book we use American terms for specific accounting concepts. The following list shows the equivalent terms in American and British usage:

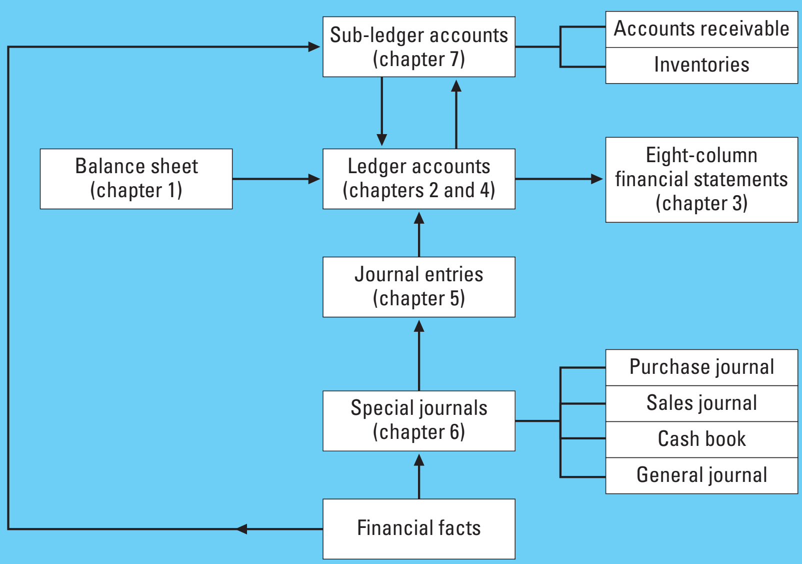
American term	**English term**
cash	bank, petty cash
accounts receivable	debtors
accounts payable	creditors
inventories	stock
note payable	bank loan
net income	profit

Part I The accounting system

1

A balance sheet shows assets and liabilities. Each firm prepares a balance sheet once a year to show stakeholders the firm's financial position. After the balance sheet has been prepared, subsequent financial facts will mean it has to be changed.
This part of the book will show how financial facts will be recorded in order to prepare a new balance sheet at the end of the year. This balance sheet will then show the starting position for the following accounting year.

The following chapters are included in this part:



Balance sheet

1

Balance sheet Each accounting process starts with a balance sheet.
A balance sheet shows assets and liabilities at a certain moment. The real values of these assets and liabilities can be determined by listing what the firm possesses.

Assets **Liabilities** **Credit side** Assets are mentioned on the debit side of the balance sheet (left), liabilities or debt on the credit side (right).

Figure 1.1

Debit	**Balance sheet 1 January** (in €)		*Credit*
Inventories	20,000	Equity	25,000
Accounts receivable	13,000	Accounts payable	14,000
Cash	6,000		
	39,000		39,000

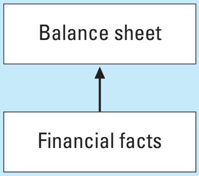
Additional information:

Accounts receivable Accounts receivable are customers who purchased goods on account; the number on the balance sheet shows the total receivable from these customers.

Accounts payable Accounts payable are suppliers from whom the firm purchased goods on account; the amount shows the total payable to these suppliers.

Equity Equity: this is a special sort of liability; it is the amount the owner of the firm would receive if the company were to be liquidated. Assets will then be sold, debt will be paid and the remainder is for the owner. If the real values of assets and liabilities equal the amounts on the balance sheet, the remainder equals equity. However, it is not a debt in the real sense of the word. If the firm's administration is separate from the owner's private administration, then it is easy to consider equity as the firm's debt to the owner. (This is known as the 'business theory'.)
A balance sheet needs to balance, which means the debit total needs to equal the credit total.
A balance sheet shows the firm's financial position at one moment. Each time something happens that may influence one or more items on the balance sheet, a new balance sheet will develop. The effect of financial facts on the balance sheet is as follows:

Figure 1.2



Example 1.1

3 January Purchased on account products with a value of €5,000.

The 'inventories' account will increase by €5,000 and the 'accounts payable' account by €5,000 as well. The new balance sheet is as follows:

Figure 1.3

Debit	**Balance sheet 3 January** (in €)		*Credit*
Inventories	25,000	Equity	25,000
Accounts receivable	13,000	Accounts payable	19,000
Cash	6,000		
	44,000		44,000

Both debit and credit sides increase by €5,000; the balance sheet stays in balance. ■

Example 1.2

4 January Paid cash to a supplier: €3,000.

The 'cash' account will decrease by €3,000 and the 'accounts payable' account will decrease by €3,000 as well.

Figure 1.4

Debit	**Balance sheet 4 January** (in €)		*Credit*
Inventories	25,000	Equity	25,000
Accounts receivable	13,000	Accounts payable	16,000
Cash	3,000		
	41,000		41,000

The equilibrium remains here as well: both sides of the balance sheet decrease by the same amount. ■

Example 1.3

5 January Sold products on account for €6,000. These products had a purchase price of €4,000.

The 'accounts receivable' account will increase by €6,000; the 'inventories' account will decrease by €4,000. The difference between the sales price and the purchase price is the gross profit.
The owner is entitled to receive this gross profit; the company's 'debt' to the owner increases, and that is why the 'equity' account increases by €2,000.

Figure 1.5

Debit	**Balance sheet 5 January** (in €)		*Credit*
Inventories	21,000	Equity	27,000
Accounts receivable	19,000	Accounts payable	16,000
Cash	3,000		
	43,000		43,000

The debit side of the balance sheet shows two changes, the credit side just one. After these changes the balance sheet is again in equilibrium.

Example 1.4

6 January Paid advertising expenses in cash, €500.

The 'cash' account decreases by €500. Advertising expenses are costs that reduce profit, and thus reduce the owner's equity by €500.

Figure 1.6

Debit	**Balance sheet 6 January** (in €)		*Credit*
Inventories	21,000	Equity	26,500
Accounts receivable	19,000	Accounts payable	16,000
Cash	2,500		
	42,500		42,500

Again, after the changes the balance sheet balances.

Exercises

1.1 a The following balance sheet will be affected by the financial facts mentioned below. Indicate the changes.

Figure 1.7

Debit	**Balance sheet 1 January** (in €)		*Credit*
Equipment	13,000	Equity	37,000
Inventories	27,000	Loan	15,000
Accounts receivable	33,000	Accounts payable	23,000
Cash	2,000		
	75,000		75,000

10 January	Purchased on account equipment with a value of €3,500.
16 January	Products sold for €1,500, cash received. The purchase price of these products was €1,000.
21 January	Paid back €1,000 on the loan.
25 January	Paid maintenance costs, €500, in cash.

b Prepare the balance sheet at 25 January.

1.2 S. Klaver Company is a retailer of open fireplaces.
On 2 January 2009 it was discovered that some of the assets and liabilities listed below belong to the firm's capital. If relevant, the amounts are based on the fair value at 2 January 2009.
Prepare Klaver's balance sheet at 2 January 2009.

- A computer with hardware, value €1,700.
- 3 fireplaces, type Warinda, total purchase price €3,600.
- 2 fireplaces, type Kolos, total purchase price €1,600.
- 4 fireplaces, type Sindor, total purchase price €6,000.
- The bank statement at 31 December 2008 shows a debit balance of €3,200.
- Outstanding receivable, J. Havelaar: €1,900 for delivering a fireplace.
- A filing cabinet, value €800.
- 1 desk with chair, value €2,700.
- 20 Unilever shares, market value per share on 2 January: €30.
- Still owing to supplier Van Houten LLC: €6,300 for delivering fireplaces.
- Still to pay: VAT €1,230.
- A document showing that the firm owes €10,000 to H.Verhoef.
- In cash, €150.

1.3 At 1 July 2009 a wholesaler in office equipment has prepared the following balance sheet (in €):

Figure 1.8

Debit	Balance sheet 1 July 2009		*Credit*
Equipment	17,400	Equity	39,820
Marketable securities	8,000	Loan	16,000
Inventories	27,520	Accounts payable	21,900
Accounts receivable	28,200	Bank loan	3,300
Cash	300	Expenses payable	400
	81,420		81,420

The inventories consist of 24 desks at €900 each and 16 chairs at €370 each.

The following financial facts relate to July 2009:

03/07	An amount of €300 was withdrawn from the bank and deposited in office cash.
08/07	Paid the expenses payable in cash, €400. This was for maintenance work, carried out in June: not paid until now, and an invoice has not been received.
10/07	Purchased 3 desks at €900 each and 5 chairs at €370 each.
14/07	Sold 1,000 shares and received €5,000 in cash. The shares were purchased for €4,500.
15/07	Paid in cash the invoice for telephone expenses, €300.
20/07	Sold on account 4 desks at €1,200 each and 3 chairs at €500 each. Furniture and invoice have been sent today.
21/07	Collected from the warehouse 1 desk and 1 chair for use in own office.
24/07	Paid a supplier €2,800 in cash and received cash from a customer, €7,620. The bank has credited our account with €4,820.
28/07	Collected from the warehouse 1 desk and 1 chair, to be used by eldest daughter in her study.
31/07	Paid €1,150 in cash for the semi-annual redemption of the loan, €1,000, and €150 interest for this period.
31/07	Depreciation on equipment for the month of July, €200.

Indicate (by date) which accounts will change and prepare the balance sheet as at 31 July 2009.